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NO. 98-1736

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1999

DONALD M. ROWE,

Petitioner,

v.

MARIETTA CORPORATION, and
JOHN S. NADOLSKI,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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In Respondents' Brief In Opposition the Respondents, Marietta Corporation and John S. Nadolski, make three arguments not addressed in the Petition for Writ of Certiorari. This reply brief will explain why those arguments are fallacious.

I.

Respondents' first argument is that the district court found "as a matter of fact" that the failure of the earnout was not proximately caused by the Defendants' fraud. However, the conclusion of the district court was a conclusion of law, not fact. The Respondents make the following representation to this Court in their Brief in Opposition, page 3:

> "The district court found *as a matter of fact* that '[Petitioner] presented no evidence that the failure of the earnout to generate $3,600,000 for [Petitioner] was related to any fraud on the part of [either Defendant].' (Pet. App. 100a)" (Emphasis added.)

It is undisputed that Rowe presented evidence and the trial court found that Marietta had materially overstated its earnings record by falsifying its earnings growth in the three fiscal years immediately preceding the transaction with Rowe. Rowe proved that Marietta had grossly overstated both its sales and its profitability, and that in the quarter

immediately preceding the transaction, Marietta had concealed the fact that it had not been profitable, but had actually lost money. (See the portions of the Sixth Circuit decision at App. p. 3a and the district court's decision at App. p. 35a quoted in the Petition for Writ of Certiorari, pages 6 and 7).

The district court's conclusion that this proof was unrelated to the failure of the earnout to produce substantial increased profits was simply an incorrect legal conclusion, not, as represented by Marietta, a finding of fact. The earnout would produce no income for Rowe unless certain stipulated profit thresholds were exceeded. Those profit thresholds contained in the earnout required an *increase* over the allegedly existing (but fraudulently inflated) profits:

> "The [earnout's] structure, however, granted Rowe only a percentage of the profits above certain earnings thresholds, set higher for each succeeding year. When the merged corporation's earnings failed to meet that threshold, Rowe would receive nothing from the provision." (Sixth Circuit decision, App. 3a).

The district court's conclusion that the overstatement of existing profits was unrelated to the failure of the earnout to reach increased levels of profits was merely an erroneous

legal conclusion concerning "loss causation."[1] That it was only a conclusion of law is demonstrated by the application of a different legal test of causation to the facts found by the district court. For example, apply the legal standard for causation of the American Law Institute's Federal Securities Code to the facts found by the district court in this case:

> "A loss 'caused' by specified conduct to the extent that (A) the conduct was a substantial factor in producing the loss, and (B) the loss was of a kind that might reasonably have been expected to occur as a result of the conduct." 1 American L. Inst., *Federal Securities Code*, 56-63 (1980).

The fraud, of course, was the material misrepresentation of Marietta's profitability for the three fiscal years preceding the transaction. Since the true earnings of Marietta were lower than represented, the

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[1]The courts below apparently assumed that since "transaction causation" and "loss causation" must each be established, the same proof cannot establish both. That this is incorrect is demonstrated in Judge Posner's opinion in Bastian v. Petren Resources Corp, 892 F. 2d 680, 685-86 (7th Cir. 1990), in the portion quoted in Rowe's Petition for Writ of Certiorari, pp. 14-15. See also Village of Arlington Heights v. Poder, 712 F. Supp. 680, 685 (N.D. Ill. 1989) (in certain cases "transaction causation and loss causation merge").

likelihood that the earnout would fail to produce *increased* profits was obviously within the foreseeable risk of harm to Rowe which was produced by the fraud.

II.

For similar reasons, the second argument submitted in the Respondents' Brief in Opposition is also erroneous. In that section, Respondents argue (Brief In Opposition, p. 5):

> ". . . the court found [that] Petitioner could not recover for his losses because the losses resulted from '[m]arket forces, not fraud' (Pet. App. 13a)."

However, as the above quoted provision of the American Law Institute's *Federal Securities Code* demonstrates, when a different legal standard of loss causation is applied it becomes apparent that where, as here, the Defendants' misrepresentation was a substantial factor in inducing the Plaintiff to enter into the transaction, legal causation is not interrupted merely because other factors also contributed to the result. As the commentary (Comment 202(19)) to the American Law Institute's *Federal Securities Code* explains:

> "The language makes it plain, for example, that if the defendant' s misrepresentation was a 'substantial factor' in inducing the plaintiff

> to buy, the defendant is not absolved merely because other factors -- for example, the plaintiff's having received a large inheritance or his having been counseled to diversify his portfolio -- contributed to this result."

In this case the "other factors" that contributed to the result were "market factors." "Market factors" are commonly present in securities fraud cases since by their very nature such cases involve interests in businesses subject to market factors. The role of market factors, should be taken into account, not as a complete bar to recovery, but in the manner stated by Professor Hazen:

> "There is ample support for requiring that in a fraudulent inducement case, once the plaintiff establishes that there was transaction causation, the burden shifts to the defendant that the loss was due to wholly independent factors."Hazen, *Treatise On The Law of Securities Regulation*, Vol. 2 at 545 (3d ed. 1995).

III.

The third argument made by Respondents' Brief In Opposition is as follows (Brief in Opposition, p. 8):

> "Although the rescissory method may be appropriate in some cases, *see Randall v. Loftsgaarden*, 478 U.S. 647, 662 (1986), the out-of-pocket method is the preferred method -- *see, e.g., Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 155 (1972); *Stone v. Kirk*, 8 f. 2d 1079, 1092 (6th Cir. 1993); *Levine v. Seilon, Inc.*, 439 F. 2d 328, 334 (2d Cir. 1971) -- and it was not error for the district court to apply it, particularly in the circumstance of this case. In any event, Petitioner has waived any claim that the use of the out-of-pocket method was error because Petitioner, on appeal, did not allege that it was error for the court not to use the rescissory method. (*See* Pet. App. 5a)."

This statement by the Respondents concerning an alleged waiver of the argument that the Randall v. Loftsgaarden method should be applied is incorrect. The case of Randall v. Loftsgaarden, 478 U.S. 647 (1986), as well as Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128 (1972) was argued in the Court of Appeals by Rowe. (See pages 43 and 44 of the Brief of Plaintiff/Appellant Donald M. Rowe in the United States Court of Appeals for the Sixth Circuit, and pages 26 and 27 of Donald M. Rowe's Reply Brief in the Sixth Circuit, now in Supplemental Appendix.) Randall v. Loftsgaarden, 478

U.S. 647 (1986) has also been relied on in the present Petition for Certiorari (page 11).

Ultimately, however, it matters not whether the rescissory method of damages of Randall v. Loftsgaarden, or the "out-of-pocket" measure is applied. Under either method, if correct legal standards are applied, Rowe would be returned to the *status quo ante*, i.e., he would recover the value he gave up as a result of the fraud.

Conclusion

Respondents' Brief in Opposition is based on the erroneous claim that the trial court's conclusions of law concerning causation were "findings of fact." The facts are not in dispute. All of the facts Rowe relies on in the Petition for Writ of Certiorari are direct quotes from the courts below. The law of loss causation was misapplied.

The Respondents' Brief in Opposition does not contest the fact that there is substantial confusion in the case law concerning the law of "loss causation." Nor does it contest the fact that over five hundred reported cases have applied the concept of loss causation in the securities fraud context. It does not contest the fact that the concept of loss causation is now in use in all circuits and that it is a consideration in every securities fraud case or controversy involving damages. It does not contest the fact that the Supreme Court has never spoken on the subject of this

important legal doctrine. It does not contest the fact that Defendants have profited by $3.7 million by committing the same fraud of which Defendant Nadolski was criminally convicted. It does not contest the fact that the innocent victim of that fraud lacks $3.7 million of being returned to the *status quo ante*.

Certiorari should be granted both to clarify the widely used concept of "loss causation" and to resolve the differences among the circuits.

Respectfully submitted,

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SUPPLEMENTAL APPENDIX

Pages 43 and 44 from "Brief of Plaintiff/Appellant Donald M. Rowe" in the United States Court of Appeals:

C. A Party Committing Fraud Must Be Required to Disgorge Those Benefits So As Not To Be Unduly Enriched

Regardless of the treatment of the other issues, it cannot be denied that, based on the district court's finding of the value of Rowe's interest in ASC, and the amount of money actually paid by Marietta, Marietta made a multi-million dollar profit from its fraud, in violation of the clear command of the U. S. Supreme Court. It is one of the firmest policies of the securities law that a party committing a fraud shall not benefit from that fraud. For this reason, the United States Supreme Court has directed that the out of pocket measure of damages should not be used when that rule would result in awarding a windfall to the wrongdoer. Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 155, 92 S. Ct. 1456, 31 L. Ed. 2d 741 (1972) states:

> "In our view, the correct measure of damages . . . is the difference between the fair value of all that the [plaintiff] received

> and the fair value of what he would have received had there been no fraudulent conduct, *except for the situation where the defendant received more than the [plaintiff's] actual loss. In the latter case damages are the amount of the defendant's profit.*" (emphasis added)

The trial court inadvertently awarded an enormous windfall profit to Marietta. As a result of the fraud, immediately after the March 17, 1989, transaction, Marietta received Mr. Rowe's interest in American Soap, which, according to the court's valuation, was worth $13,654,008. Yet Marietta paid to Mr. Rowe a total of only $9,935,654. Thus it received a profit from the fraud of at least $3,712,964, plus interest-free use of that money since March 17, 1989.

However, if the value of Mr. Rowe's interest in American Soap that was established by the transaction is used by the court (as it should be), we see that Marietta received value in the amount of $14,676,387, in exchange for payment to Mr. Rowe of $9,935,654. Thus, Marietta profited by its fraud in the amount of $4,740,733, plus interest-free use of that sum since March 17, 1989.

Though the trial court was apparently aware of the Affiliated Ute command that it must deviate from the out of

pocket measure of damages when necessary to prevent the fraudulent party from profiting from the fraud (see the reference to Affiliated Ute in the trial court's opinion at page 39), the trial court failed to follow the Supreme Court's clear and absolute directive in this regard, and was apparently unaware that the result of the judgment rendered was to award Marietta a multi-million dollar profit from the fraud.

New York law and federal securities law both require that the wrongdoer disgorge the profit from its fraud. The Supreme Court relied on New York law in Randall v. Loftsgaarden, 478 U.S. 647 at 663, 106 S. Ct. 3143, 92 L. Ed. 2d 525 (1986):

> "But the court in Affiliated Ute Citizens also indicated that 'where the defendant received more than the seller's actual loss . . . damages are the amount of the defendant's profit.' *Ibid.* This alternative standard aims at preventing the unjust enrichment of a fraudulent buyer, and it clearly does more than simply make the plaintiff whole for the economic loss proximately caused by the buyer's fraud. Indeed, the accepted rationale underlying this alternative is simply that '[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them.' Janigan v.

> Taylor, 344 F. 2d 781, 786 (CA1), cert. denied, 382 U.S. 879, 86 S. Ct. 163, 15 L.Ed. 2d 120 (1965). *See also Falk v. Hoffman, 233 N.Y. 199, 135 N.E. 243 (1922) (Cardozo, J.).*" (emphasis added)

The referenced decision is by Judge Cardozo in the case of Falk v. Hoffman, 233 N.Y. 199, 135 N. E. 243 (1922). The Falk case involved a fraudulent transaction in stock, and held, applying New York law, that the wrongdoing defendants must account for and disgorge the proceeds and ensuing profits resulting from the fraud.

These holdings are, of course, in accordance with the universally recognized rule, as stated in the RESTATEMENT, RESTITUTION, §3: "A person is not permitted to profit by his own wrong at the expense of another."

Pages 26 and 27 from "Donald M. Rowe's Reply Brief" in the United States Court of Appeals:

Marietta has no rebuttal of the cases cited by Rowe establishing that both New York law and federal securities law require that the wrongdoer disgorge the profits from its fraud. This is the command of Randall v. Loftsgaarden, 478 U.S. 647, 106 S. Ct. 3143, 92 L. Ed. 2d 525 (1986), of Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 155,92 S. Ct. 1456, 31 L.Ed. 2d 741(1972), and of Judge Cardozo's decision in Falk v. Hoffman, 233 N.Y. 199, 135 N.E. 243 (1922), as well that of the RESTATEMENT, RESTITUTION, §3: "A person is not permitted to profit by his own wrong at the expense of another."

Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 155, 92 S. Ct. 1456, 31 L. Ed. 2d 741 (1972) states:

> "In our view, the correct measure of damages . . . is the difference between the fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct, *except for the situation where the defendant received more than the [plaintiff's] actual loss. In the latter case damages are*

the amount of the defendant's profit."
(emphasis added)

In other words, a defendant who has committed securities fraud cannot profit therefrom and must refund its profit to the victim of its fraud. Note that the Supreme Court did not say that damages "may" be the amount of profit. It states that the damages "are" that amount.

In Randall v. Loftsgaarden, 478 U.S. 647 at 663, 106 S. Ct. 3143, 92 L. Ed. 2d 525 (1986) the Supreme Court stated:

> "But the court in Affiliated Ute Citizens also indicated that 'where the defendant received more than the seller's actual loss . . . damages are the amount of the defendant's profit.' *Ibid.* This alternative standard aims at preventing the unjust enrichment of a fraudulent buyer, and it clearly does more than simply make the plaintiff whole for the economic loss proximately caused by the buyer's fraud. Indeed, the accepted rationale underlying this alternative is simply that '[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them.' Janigan v. Taylor, 344 F. 2d 781, 786 (CA1), cert.

denied, 382 U.S. 879, 86 S. Ct. 163, 15 L.Ed. 2d 120 (1965). *See also Falk v. Hoffman, 233 N.Y. 199, 135 N.E. 243 (1922) (Cardozo, J.).*" (emphasis added)